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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268-0001

Statutory Review of the System For Regulating Rates and Classes For Market Dominant Products	)))))	**Docket No. RM2017-3**

Comments of Discover Financial Services
March 1, 2018

Discover Financial Services (DFS) submits these Comments in response to the Notice of Proposed Rulemaking for the System for Regulating Rates and Classes for Market Dominant Products (Notice), released in this Docket as Order 4258 on December 1, 2017. As explained below, the changes proposed by the Commission should not be finalized and a further NPRM should be released to consider other options.

I
The Instant Docket

The Commission opened this Docket in December of 2016 in order to conduct the review of the Commission's ratemaking system that was mandated by the PAEA when it passed in 2007. See 39 USC §3622(d)(3). The ratemaking system was created by the Commission itself pursuant to the PAEA. See 39 USC §3622(a). The purpose of this review is to consider the performance of the ratemaking system in light of the objectives and factors listed in 39 USC §3622 (b) and (c) over the last ten years.

On December 1, 2017, concurrent with the Release of this Notice, the Commission released its findings concerning its review of the system in Order 4257. In that Order, the Commission found that the ratemaking system has not fully achieved its objectives. Order 4257 at 275. The instant Rulemaking was initiated to change the ratemaking system to fix that failure.

One of the issues in play in this docket is the breadth and depth of the Commission's Legal and Constitutional authority to change the ratemaking system and its signature element for market dominant products, the price cap. DFS will not address the Legal and Constitutional issues but will leave them for other commentators.

DFS's concerns are more pragmatic. First, the proposed changes do not address one of the prime elements driving revenues out of the Postal Service, the diversion of marketing dollars from direct mail marketing to direct digital marketing. Second, the proposal does not consider the performance of the ratemaking system within the wider context of the burden of the compressed time frame for prefunding retiree health benefits.

Without addressing these two matters, the proposed changes set forth in the Notice will *not* fix the fundamental problems behind the Postal Service's current financial problems. Indeed, we respectfully submit that the proposal would actually make the Postal Service's financial predicament worse.

DFS agrees with the proposition implicit in the proposed regulations that it is time to eliminate cross-subsidizes in which one group of mailers covers the costs of another group. Finally, DFS strongly agrees with Commissioner Hammond's point that this

Order overlays questionable regulatory complexity on the ratemaking process. That is *precisely* what the Postal Service at this point does not need.

II
Mail Marketing And Digital Marketing

One of the two biggest challenges to the Postal Service's financial future is its loss of revenue to digital direct marketing and digital delivery of bills and payments. DFS is a direct bank and payment financial services company that offers credit card services and other financial service products under the Discover® Card and other Discover® brands. As a direct bank, DFS has little retail brick and mortar, no branch network, and offers its services remotely via online banking and telephone banking as well as ATMs, mobile, and mail. DFS thus has considerable expertise with the digital world and relies upon its mastery of digital technology.

Historically, DFS also has extensively used direct mail. Indeed, DFS is one of the largest First-Class and Standard Mail letter mailers in the United States. It has won awards for its quality, creativity, and dedication to the postal channel.

Over the years, however, DFS has increased the share of marketing dollars directed towards digital direct marketing channels to the detriment of DFS's mail spend. Fully aware that DFS's shift to digital was costing the Postal Service millions of dollars per year, it sat down with DFS to try to work out an NSA structure to ameliorate this situation. In October 2014, the Postal Service filed with the Commission an NSA structure that would have given DFS a financial rebate if it met higher revenue thresholds. Notice of the United States Postal Service of Filing Request To Add Discover Financial Services Negotiated Service Agreement to the Market-Dominant

Product List, Dockets MC2015-3 & R2015-2 (October 37, 2015). The Postal Service estimated that it would gain $115.7 million over the term of the NSA. Id. at 5.

As DFS and the Postal Service were considering options for ameliorating digital diversion, DFS found that its digital marketing efforts had significantly increased in effectiveness. It revised its forecasts and contingently planned on shifting more than $100 million dollars from postal to other channels, specifically including digital, over a three year period, absent the NSA. Had the NSA been approved, DFS would not have shifted all of this $100 million, but would have focused on increasing its mail projects.[1]

The Commission rejected the NSA and essentially ignored the digital diversion justification even though digital diversion was one of the primary drivers for passage of the PAEA, and something that has a big impact on DFS's mail spend. Despite this, the Commission concluded that if it approved the DFS NSA, the Postal Service would lose up to $20 million because it was not necessary to incent DFS's growth. Order 2140 March 24, 2015 at 10-12. History has proven that the Commission's conclusion was wrong.

Since rejection, DFS has done exactly what it said it would, and pulled more than $100 million out of direct mail and into other channels, specifically including direct digital marketing. This is a substantial—and verified—loss for the Postal Service. DFS does not present this information as a "We told you so" but rather as a valuable learning experience to guide the Commission in its current rulemaking.

[1] This shift was explained to the Postal Service and the Commission by Discover's CMO Harit Talwar in a Statement filed with the Commission during the NSA proceeding. See Appendix I.

Since 2014, the trend of dollars shifting from Standard Mail to digital has continued for DFS and many other companies. How fast those mail customers will continue this shift in the future is dependent on the price of mail. Revenue and volume shifts will depend upon price changes, each company's unique circumstances, and each company's business relationship with digital marketing service providers as well as with the Postal Service. As more and more companies become adept at digital marketing, the trend will increase.

Particularly important in trying to deal with such trends is an understanding that companies need to have sufficient lead time to analyze their markets and set specific marketing targets, as well as sufficient time to formulate and design the marketing campaigns. Therefore, if a company is deciding between digital and mail for a campaign, and the price of mail is uncertain for the entirety of that campaign, mail is at a competitive disadvantage in the battle for marketing dollars. DFS and other mailers need certainty in mail pricing in order to maximize their postal spend. Instituting a price increase on short notice negatively impacts the efficiency of a company's campaigns to the advantage of digital campaigns. That was the beauty of the price cap and of DFS's NSAs. Even though one didn't quite know the rate years ahead of time, there was a definitive and certain structure that would not be changed absent exigent circumstances.

Of course, the size of the increase is more relevant than the certainty of the increase. The enormous size of the rate increases that the proposal would allow seems tailored to drive mail out of the system and move customers into digital. Mail is already much more expensive than digital at today's rates. The pending proposals, if adopted, would allow the Postal Service to increase rates by almost 15 percent over five years. This cannot help but drive mail out of the system.

The Commission, via the ratemaking structure, needs to allow the Postal Service to address digital diversion. However, the current proposal does not take these dynamics into account. The current structure needs to be replaced with a mechanism that gives the Postal Service the pricing flexibility to give rate certainty to a mailer and allows the Postal Service to quickly—in days or weeks rather than months—respond to market forces, and set prices far ahead of time. For example, this could consist of an incentive system with rebates for a mailer when it reaches certain mail thresholds.

An ability to counter the growth of digital replacements for mail is essential to the future of the Postal Service. The continuation of a rigid ratemaking system—or one proposed to be even more rigid—will not do this.

III
Pre-funding Retiree Health Benefits

There is a general consensus among the postal community that the principal cause of the Postal Service's financial difficulties is not the structure of the PAEA's ratemaking system. Rather the principal cause is the onerous requirement that the Postal Service prefund its retiree pensions and health benefits in a highly compressed time period by 100%, thus greatly increasing the size of the annual payment. The prefunding requirements added $5.6 billion per year to the Postal Service costs from

2007 to 2016.[2] The burden of this annual payment has been crippling the postal system.

Between the enactment of the PAEA in 2007 and 2016 the Postal Service lost a total of $62.4 billion, with $54.8 of that total related to retiree health care.[3] At the end of FY 2016 the assets in The Postal Service's retirement liability accounts totaled $338.4 billion, and the liabilities totaled $411.8 billion, resulting in these liabilities being funded at 82.2 percent.[4]

Given these facts, the most reasonable conclusion is that these prefunding issues are responsible for the weakened financial condition of the Postal Service. Therefore, any reasonable evaluation of the ratemaking system and its ability to ensure adequate revenues to maintain USPS financial stability must address the role of the prefunding issue in the Postal Service financial predicament *and* acknowledge that achieving USPS financial health is not going to be accomplished without addressing the prefunding issues.

The Commission appears to acknowledge that the cause of the Postal Service's financial woes is the prefunding issue for it cites numbers similar to the IG: "The accumulated deficit of $59.1 billion in FY 2016 includes 54.8 billion in expenses related to prefunding." Notice at 27. But it appears that the Commission does not acknowledge that "fixing" the ratemaking system is not going to compensate for the prefunding

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[2] Office of the Inspector General, United States Postal Service, IG Report Number FT-AR-17-007 (May 2, 2017) at 1.
[3] Id.
[4] Id. Note that in FY 2010 the status of the pension liabilities and payments was such that there was a surplus. In 2014 that status changed dues primary to assumptions for interest rates, cost of living allowances, and lower than expected investment returns on pension plan assets. Id at 2.

burden and it does not explicitly acknowledge that "fixing" the ratemaking system is not going to create financial stability for the Postal Service:

> The exiting ratemaking system did not achieve the PAEA objectives during the 10 years following the PAEA's enactment. The Postal Service is in poor health. . . . The market dominant ratemaking system established under 39 U.S.C.§3622 did not assure 'adequate revenues, including retained earnings, to maintain financial stability,' as required by Objective 5. . . . Therefore the Commission considers regulatory proposals aimed to put the Postal Service on the plan to financial stability.

Notice at 27-28. In making this point, the Commission ignores the prefunding issue and seems to imply that the Postal Service's poor health is the fault of the ratemaking system.[5]

The Commission must realize and should specifically acknowledge that any revision of the ratemaking structure is *not* going to accomplish the objective of ensuring adequate revenues to achieve or maintain financial stability. The prefunding numbers are simply too great and, without relief from Congress, they are unavoidable. The Commission should strongly recommend that Congress fix the prefunding issues, and as it modifies the ratemaking structure clearly acknowledge that financial stability for the Postal Service will not be accomplished by this alone.

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[5] The views of two of the Commissioner's in their separate and dissenting statements are instructive. Commissioner Hamilton was quite specific when he said "the existing ratemaking system has not provided the Postal Service with revenues adequate to maintain financial stability. However, I have also concluded that a significant portion of the Postal Service's financial instability results from an overly aggressive retiree health benefits prefunding schedule—which warrants a legislative solution." Dissenting Views of Commissioner Tony Hammond at 2. Commission Action implicitly recognizes the role of the prefunding burden when he points out that the Commission does not have ability to allow the Postal Service to re-amortize unfunded liabilities. Supplemental Views of Vice Chairman Mark Action at 1.

Given the bind caused by the prefunding burden, the Commission should approach the ratemaking system modification by borrowing a basic tenant from the medical profession, “First, Do No Harm.” With that in mind, if the Commission can do nothing about the impact of the prefunding system, and if the Postal Service cannot achieve financial stability until the prefunding issue is fixed, then the Commission should—loudly and clearly—say that the prefunding structure and not the ratemaking structure has crippled the Postal Service finances.

Rather than try to achieve the impossible by forcing the ratemaking system to fix a problem that only Congress can fix, the Commission can focus its efforts to use the ratemaking system to address the type of financial pressures that it can address. Among them is helping the Postal Service do what it can to adjust rates to minimize digital diversion, and to continue certainty in rate increases, remembering that mail’s cost is already much higher than digital’s cost.

IV
Classes Where Revenues Do Not Cover Costs.

There are a number of classes where revenues are not covering 100% of attributable costs. In these cases, DFS and others are cross-subsidizing the underwater products. This is unfair and continues to put more pressure on the sources of the subsidies to shift away from mail. A healthy postal system requires all classes to cover all of their attributable costs. No mailer should subsidize another mailer. These regulations seek to accomplish this and DFS supports that goal.

V
Commissioner Hammond's Point About Questionable Regulatory Complexity.

In his dissenting option, Commissioner Hammond makes an very astute point:

> A second concern I have is the questionable regulatory complexity that this Order seeks to overlay on what has been, until now, a straightforward and pragmatic ratemaking system. For example, tying 0.75 percent of pricing authority to Commission-approved efficiency and 0.25 percent of pricing authority to Commission-approved service performance creates unnecessary regulatory hurdles.

Hammond at 2,

DFS strongly agrees with Commissioner Hammond and urges the Commission, in its next round of proposals, to eliminate the unnecessary regulatory hurdles that the Commission has created in this round. Unnecessary regulatory hurdles are *exactly* what the Postal Service does not need, as it battles with digital diversion. Indeed, the Commission should do everything it can to facilitate, rather than hinder the Postal Service's ability to set prices in a way that slows digital diversion, subject to the constraint that rates must cover costs.

Conclusion

For the reasons indicated above, the Commission should not finalize the proposed ratemaking structure but put out a further Notice with proposals that remove the regulatory hurdles that hinder the Postal Service's ability to deal with digital diversion. If the Postal Service does not deal successfully with digital diversion, then its future is bleak indeed. DFS' rejected NSA provides verified proof that postal rates in

Standard Mail have a strong negative effect on mail volume and revenue due to the very competitive nature of today’s marketing environment. Moreover, the Commission must send a signal that, because of the prefunding issue, a new ratemaking structure will not cure the Postal Service’s financial ills. Only Congress can accomplish that.

Thank you for considering our views.

Respectfully submitted,

/s/ Robert J. Brinkmann

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